Subprime Foreclosures

Patrick Madigan
Assistant Attorney General

Current Foreclosure Rates

- In the 2nd Quarter of 2007, 14.82% of all subprime loans were delinquent and 5.52% in foreclosure
  - 16.95% of subprime ARMs are delinquent. This is highest level on record.
  - 8.02% of subprime ARMs are in foreclosure.
  - Approximately 75% of all subprime loans are ARMs.

Iowa Foreclosure Rates

All Subprime Loans

- 14.51% delinquent
- 8.63% in foreclosure
  - 4th in the country

Subprime ARMs

- 19.30% delinquent
- 13.70% in foreclosure
  - 3rd in the country

Subprime Loans and Homeownership

- This market is not necessarily about increasing home ownership.
  - Only 10-15% of subprime loans are for first-time home buyers
- Center for Responsible Lending estimates subprime loans have produced a <u>net</u> <u>loss</u> in homeownership
- People who have owned their homes for years lose it to a subprime refinancing
- Subprime lenders made it very easy for people to get into a home but hard to stay in the home

The 2/28 Problem

- Use of an artificially low interest rate with a high margin
- Loans begin to adjust upward after 2 years, producing “payment shock”
  - Continue to adjust every 6 months
- These high delinquency rates are <u>before</u> most ARMs have reset to a higher payment
- 2006 loans are performing very badly
- Problems to date are due to weak or non-existent underwriting, risk layering, origination fraud and life events

The 2/28 Problem (cont.)

- Estimated that 1.8 million ARMs worth around $900 billion will adjust in 2007 and 2008
- Foreclosures will continue to increase
- This is a slow motion train wreck that will play out over the next 12-18 months

Economics of Foreclosures

- Each foreclosure represents total losses of $80,000 (losses to the homeowner, lender, and community at large)
- Lenders are averaging losses of $50K on every foreclosure
  - On average, will only get 50 cents on the dollar when foreclosed property is sold
  - Situation is even worse if an inflated appraisal was used
  - Also have to include costs of foreclosure process

Secondary Market

- Most subprime loans are bundled and sold to secondary market investors in what is known as securitization
- Payments are collected by a servicer, who may or may not be the originator
- Servicer’s duty is to secondary market investor, not the borrower
- Relationship between the investors and the servicer is governed by a pool and servicing agreement

Secondary Market (cont.)

- Pool and servicing agreement contains rules on when and how loan modifications can be made
  - Common terms include:
    - Servicer can modify loans that are either in default or default is either imminent or reasonably foreseeable
    - 5% aggregate cap on the pool
    - Some do not allow modification until borrower is 90 days late

Secondary Market (cont.)

- Investors are not a homogenous group
  - Are in different grades or tranches
  - What tranche you are in determines when you take a loss
- Some investors actually want loans to fail
  - Hedge Funds have taken derivative positions
- American Securitization Forum issued a guidance in June 2007 to bring some standardization to the industry
  - Told servicers to treat investors in the aggregate
  - Gave guidance on what is reasonably foreseeable default
    - very significant events that allowed servicers to move forward with loss mitigation

Investor Issues Have Prevented Modifications

- Previously, servicers were not doing modifications because of uncertainty regarding PSAs and tax issues.
- Some investors are against modifications, claiming you are delaying the inevitable
  - It has been reported that up to 40% of modified loans re-default
  - Estimated that 10% of investors are still against modifications

Investor Impediments Have Been Largely Removed

The Good News:

- Investors are starting to come around as the market continues to deteriorate
  - Now officially recognize the obvious, that a modification is better than a foreclosure when:
    - “Net present value of the payments on the modified loan are likely to be greater than the anticipated net recovery that would result from foreclosure”

Investor Impediments Have Been Largely Removed (cont.)

- Pool and servicing Agreement restrictions on modifications have been removed in recent weeks
- They are not the impediment they once were
- But, fear of investor lawsuits persists
- All servicers say it is not a matter of if, but when they will be sued

Servicer Impediments to Modifications

- The myth of if the borrowers will just talk to us, we will work something out
- Servicers have their own issues, beyond pool & servicing agreements:
  - Disconnect
    - Frontline people answering the phones are not getting the message
    - Just like the originations, big difference between what top management is saying and what employees are doing
  - High turnover in servicing staff
  - View their job through a collections viewpoint, rather than a loss mitigation standpoint

Servicer Impediments to Modifications (cont.)

- Profit margins are thin
  - Servicing costs are going up every month
- Servicing was designed to be highly automated
  - Modifications are a loan-by-loan process
  - There is no cookie cutter solution
  - Modifications are time and resource intensive

Servicer Impediments to Modifications (cont.)

- Servicers are just not set up for this
  - It is not a tool in their toolbox
  - Need to hire more people
  - Need to spend a lot more time per loan
  - Might need to be paid extra for their efforts
- Many of the large servicers today have little experience with a down market

What Can Be Done

- Put pressure on servicers to work with borrowers
  - Federal regulators issued a joint statement on April 17th and again in September urging banks and credit unions to work with borrowers
  - The Agencies recognized that prudent workout plans are generally in the long-term best interests of both the lender and the borrower
  - American Securitization Forum has also recognized the value of modifications

Help Put Borrowers in Contact with Servicers

- 50% of borrowers who are foreclosed upon never talk to their servicer
- Borrowers will sometimes talk to a non-profit or other third party
- Iowa Foreclosure Hotline
  - 2,100 calls in the first month